IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

NO. 964

FIRST NATIONAL BANK IN WEST UNION, WEST VIRGINIA, a Corporation, Petitioner,

v.

AMERICAN SURETY COMPANY OF NEW YORK, a Corporation, Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, *First National Bank in West Union, West Virginia,* a national banking association, respectfully represents that it is aggrieved by the judgment of the United States Circuit Court of Appeals for the Fourth Circuit, rendered on the 9th day of March, 1944, in an action prosecuted by Respondent, *American Surety Company of New York,* a corporation, against Petitioner, insofar as and to the extent that the judgment of the Court of Appeals reversed the judgment theretofore rendered in favor of Petitioner by the United States District Court for the Northern District of West Virginia. The portion of the judgment of the Court of Appeals herein complained of allowed a recovery by Respondent

against Petitioner to the extent of $4,050.00 (R. 337), representing bankruptcy funds deposited with Petitioner by the Trustee of a bankrupt's estate and later misappropriated by the Trustee. Respondent was surety on the Trustee's bond.

Petitioner respectfully prays for the allowance of a writ of certiorari directed to the United States Circuit Court of Appeals for the Fourth Circuit, in order that the portion of its said judgment of March 9, 1944, adverse to Petitioner, may be reviewed by your Honorable Court.

In the interest of brevity, Petitioner's supporting brief is combined herein with, and as a part of, the Petition.

OPINIONS BELOW.

The opinion of the Circuit Court of Appeals for the Fourth Circuit, not yet officially reported, is printed at pages 324 to 337 of the Record herein. The opinion of the District Court of the United States for the Northern District of West Virginia is reported in 50 Fed. Sup. 180 (1943), and is printed in the Record (R. 74-93).

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on March 9, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended, being Section 347 of Title 28, USCA.

THE QUESTION PRESENTED.

The question which was decided adversely to Petitioner by the Circuit Court of Appeals, and which is of national significance and importance beyond the present case, may be stated as follows:

> *Whether a bank, which has not been designated as a depository for bankruptcy funds under Section 61 of the Bankruptcy Act, becomes a trustee ex maleficio of bankruptcy funds deposited by the Trustee of a bankrupt's estate in the ordinary course of business in a general account in the bank in which he regularly deposited both personal and trust funds, and the bank thereby automatically becomes liable to the bankrupt's estate for subsequent misappropriations of such funds by the Trustee, even though the bank admittedly had no knowledge of any misapplication or intended misapplication of the funds by the Trustee, received no benefit from the transaction, and was not conscious of any impropriety in accepting such deposit.*

STATEMENT OF THE MATTER INVOLVED.

This was an action prosecuted in the District Court of the United States for the Northern District of West Virginia by Respondent, American Surety Company of New York, against Petitioner, First National Bank in West Union, West Virginia (hereinafter referred to as "Bank"), to recover the sum of $4,843.62, with accrued interest, representing bankruptcy funds deposited in his personal account in the Bank by one Clyde C. Ware, Trustee of the estate of Eli Nutter, bankrupt, and later misappropriated by the Trustee. Respondent was surety upon the Trustee's bond. After the defalcations were discovered, and Ware had been removed as Trustee, Respondent paid the loss to the successor Trustee of the bankrupt's estate, and obtained an assignment of subrogation rights. This assignment was obtained by Respondent on April 26, 1938 (R. 62), but the present action against the Bank was not instituted until more than four years later, on August 22, 1942 (R. 2).

Respondent invoked the jurisdiction of the District Court on the ground of diversity of citizenship (R. 2), and sought to recover against the Bank because of the following transactions had by the Trustee in bankruptcy with Petitioner:

(1) The Trustee deposited eight checks, representing $4,050.00 of bankruptcy funds, in a general account which he carried in the Bank and in which he deposited both personal and trust funds, and later withdrew the bankruptcy funds by checks drawn against said account and misappropriated them. Petitioner was not a designated depository for bankruptcy funds, and never had been.

(2) The Bank cashed for the Trustee checks aggregating the sum of $793.62, which were payable to him in his capacity as Trustee of the bankrupt's estate. The proceeds of the checks were misappropriated by the Trustee.

The Bank admittedly had no knowledge of misapplication or intended misapplication of any of these funds by the Trustee. The Trustee was not indebted to the Bank, and Petitioner received no benefit or profit from the transactions. Ware was a regular and respected customer of the Bank, which was located in the small county seat town where he resided, and in a rural community where there was no designated depository for bankruptcy funds in the entire county. The District Court, applying the established law of West Virginia to these transactions, held that there was no liability on the part of the Bank, and entered judgment in favor of Petitioner. The Circuit Court of Appeals affirmed the District Court in its holding that the Bank was not liable for the item of $793.62, covering checks payable to the Trustee which were cashed by the Bank, but reversed the District Court upon the item of $4,050.00, representing the amount of checks for bankruptcy funds deposited by the Trustee in the Bank.

The facts which give rise to the important question here presented are wholly undisputed, and may be briefly stated.

1. On or about October 10, 1934, Clyde C. Ware became Trustee of the estate of Eli Nutter, bankrupt, in bankruptcy proceedings had in the District Court of the United States for the Northern District of West Virginia (R. 58). Ware resided in the town of West Union, the county seat of Doddridge County, West Virginia.

The town has a population of approximately 1500 people (R. 75). It is a rural community.

2. Respondent, American Surety Company of New York, was surety on the Trustee's bond for $5,000.00, furnished in the bankruptcy proceeding (R. 58).

3. Petitioner is a small country bank. At the time of the transactions in question, it had about 2500 active accounts of depositors, on which about 500 checks were drawn daily; and had four regular employees, consisting of a cashier, assistant cashier, and two bookkeepers (R. 75). There were only two banking institutions in the town, of which Petitioner was one; and neither of them was a designated depository for bankruptcy funds (R. 75). In fact, there was no such designated depository in all of Doddridge County, the nearest one being located at Clarksburg, approximately thirty miles away.

4. On or about August 27, 1937, Ware received eight checks or drafts, aggregating $4,050.00, from Pittsburgh and West Virginia Gas Company, covering gas rentals due the bankrupt's estate (R. 59). The checks were drawn upon a bank at Pittsburgh, Pennsylvania, and were all made payable to the order of "Clyde C. Ware, Trustee in Bankruptcy of Eli Nutter, Stuart Building, West Union, W. Va." (R. 59). Ware endorsed each of the eight checks in blank "Clyde C. Ware, Trustee in bankruptcy of Eli Nutter", and deposited them in the Bank in a general account which he had maintained there for a number of years (R. 60). Ware kept only this one general account in the Bank, in which he deposited fiduciary and trust funds, as well as his personal funds (R. 164-5). The proceeds of the checks were credited by the Bank to this account, subject to

their ultimate payment (R. 60). The checks were paid by the Pittsburgh bank in the usual course of business, and between August 27 and December 6, 1937, the proceeds, amounting to $4,050.00, were withdrawn by Ware upon personal checks and misappropriated (R. 60). None of the checks were countersigned by a referee in bankruptcy or other officer of the bankruptcy court (R. 60-1).

5. Between August 31, 1937, and December 1, 1937, Ware received ten additional checks, aggregating $600.00, from Pittsburgh and West Virginia Gas Company, drawn upon a bank at Pittsburgh, Pennsylvania, and all made payable to "Clyde C. Ware, Trustee in Bankruptcy of Eli Nutter, Stuart Building, West Union, W. Va." (R. 65). After endorsing these checks in blank "Clyde C. Ware, Trustee in bankruptcy of Eli Nutter", Ware presented them to the Bank and received cash therefor (R. 66). During the same period, Ware received two other checks, aggregating $193.62, from Hope Natural Gas Company, drawn upon a bank at Pittsburgh, Pennsylvania, and payable to the order of "Clyde C. Ware, Trustee, West Union, W. Va."; and after endorsing both these checks in blank "Clyde C. Ware, Trustee", they were also cashed by the Bank (R. 66-7).

6. At the time of these transactions between Ware and the Bank in 1937, Ware was a leading and respected attorney in the town of West Union, enjoying probably the largest law practice in the entire county (R. 172, 193, 195). He was President of the Kiwanis Club at West Union (R. 160-1, 193), and was generally highly regarded in the community. He represented the Home Owners Loan Corporation in Doddridge County, and handled the checks covering its loans (R. 161). The

Bank had no reason to suspect any misappropriation by Ware of bankruptcy funds, nor did it receive any benefit from the transactions. In this connection, the District Court made the following Findings of Fact:

> "5. No part of the proceeds of any of the checks involved in this action, or any other assets of the bankruptcy estate were used to pay overdrafts or other personal obligations of Ware to the defendant bank. The bank did not profit or receive any benefit from the manner in which Ware negotiated and applied the proceeds of these checks, other than that incident to the relationship between bank and depositor.
>
> 6. Neither the bank, nor any employe or officer thereof had notice or knowledge that Ware was wrongfully or illegally applying the proceeds or commercial values of such checks to his personal use.
>
> 7. The bank did not have notice sufficient to put it on inquiry that the proceeds of such checks, or any part thereof, were being wrongfully withdrawn by Ware, and was guilty of no negligence.
>
> * * * * * * *
>
> 9. Defendant and its officers and employes, presumed and believed Ware to be honest and that he would properly and lawfully apply the funds deposited.
>
> 10. The bank did not itself misappropriate or actually participate in the misappropriation of any of said trust funds." (R. 90-1).

The Court of Appeals agreed that the Bank had no knowledge of the misappropriations, saying:

> "We find no evidence of knowledge on the part of the Bank of any misappropriation of funds by the

Trustee, except such as was involved in the deposit of bankruptcy funds in his private account in a Bank which was not an authorized depository" (R. 335).

The cashier of the Bank knew, of course, that Petitioner was not a designated depository for bankruptcy funds, and he testified that the checks deposited by Ware "would indicate that they were bankruptcy funds" (R. 139). However, the cashier had no reason to believe it would be improper for the Bank to accept the deposit. He testified:

"* * * I didn't know whether they were required to be passed through the trustee, or whether he had, some of these particular checks were to be handled from, some other way, in some other way. He was one of our leading attorneys there, and I took it for granted that he knew what he was doing. He had always been very responsible." (R. 139).

In its opinion, the Court of Appeals concedes the cashier's innocence, but says he was mistaken as to the legal consequences of the acceptance of the deposit:

"He (the cashier) testified that he thought that the restrictions did not prevent the acceptance by an unauthorized bank of bankruptcy funds provided they were deposited by the Trustee to his personal account. He evidently overlooked the inherent breach of trust involved in such a deposit by the trustee". (R. 328).

7. On December 6, 1937, an order was entered in the bankruptcy proceeding, directing Ware to make distribution of the bankruptcy funds (R. 61). Thereafter, upon the discovery that he had misappropriated funds,

Ware was removed as Trustee, and a new Trustee was elected in his stead on or about February 28, 1938 (R. 61). On March 30, 1938, the successor Trustee made claim against Respondent, as surety on Ware's bond, and on April 26, 1938, the referee entered an order adjudging Respondent to be liable for $5,000.00, the face amount of its bond (R. 61-2).

8. On April 26, 1938, Respondent paid to the successor Trustee the sum of $5,000.00 in settlement of its liability on Ware's bond, and received in return a subrogation assignment (R. 62-4). More than four years later, on August 22, 1942, Respondent instituted this action against Petitioner in the District Court (R. 2).

9. The case was heard before the District Court without a jury upon an agreed statement of facts, supplemented by some oral testimony. The District Court held, in a written opinion (R. 74-89), with appropriate Findings of Fact and Conclusions of Law (R. 89-93), that there was no liability on the part of the Bank. The District Court's Conclusions of Law included the following:

> "1. Not being a designated depository of bankruptcy funds, the defendant bank was not subject to the laws and statutes and General Orders in Bankruptcy relating to such depositories.
>
> 2. Defendant's alleged liability must be tested by the law of West Virginia. *Erie R. Co. v. Tompkins,* 304 U. S. 64; *Metropolitan Life Ins. Co. v. Goodwin,* 4 Cir., 92 F. (2d) 274.
>
> 3. The law in West Virginia on this subject is as follows: To render a bank of deposit liable for the default or misappropriation by a fiduciary of a

trust fund deposited it must have actually participated therein, or with knowledge reaped some benefit therefrom, as by itself. Appropriating the money or receiving it in payment of some individual indebtedness of the fiduciary to it and thereby rendering itself liable as trustee or otherwise. *United States Fidelity and Guaranty Co. v. Home Bank,* 77 W. Va. 665, 88 S. E. 109; *United States Fidelity & Guaranty Co. v. Hood* (1940), 122 W. Va. 157." (R. 91).

10. Upon appeal, the Circuit Court of Appeals affirmed the judgment of the District Court, insofar as the District Court absolved the Bank of any liability for the item of $793.62, covering checks which the Trustee cashed at the Bank, the Court of Appeals saying:

> "We find no evidence of knowledge on the part of the bank of any misapplication of funds by the Trustee except such as was involved in the deposit of bankruptcy funds in his private account in a bank which was not an authorized depository; and this is not sufficient, we think, to charge the bank with notice of intended misapplication of the proceeds of checks which he collected in cash." (R. 335).

However, the Court of Appeals reversed the District Court's judgment "in so far as it relates to liability for the checks aggregating $4,050.00, which it received for deposit and credited to the personal account of the Trustee" (R. 335-6).

Conceding that the Bank had no knowledge whatsoever of any misapplication of funds by the Trustee, the Court of Appeals based its reversal as to the $4,050.00 item upon this very narrow ground: that as

the Bank was not a designated depository for bankruptcy funds, as contemplated by Section 61 of the Bankruptcy Act, the mere deposit of the checks aggregating $4,050.00 in the Bank by the Trustee in his personal account imposed absolute liability upon the Bank, as a trustee *ex maleficio,* when the Trustee later misappropriated these funds. The Court of Appeals said:

> "The deposit itself constituted a breach of trust on the part of the trustee * * * and upon the receipt of the deposit under such circumstances, the bank became a trustee ex maleficio of the amount so received and liable therefor as a trustee to the estate of the bankrupt" (R. 326).
>
> "A deposit of bankruptcy funds in an unauthorized depository gives rise to a constructive trust, or a trust ex maleficio" (R. 329).
>
> "The liability of the bank with respect to the deposit is that of a constructive trustee, or trustee ex maleficio, for the bankrupt estate. As the funds involved in the deposit have not been returned to the estate, the bank is liable therefor to the estate, or to plaintiff as assignee of the rights of the estate." (R. 334).

BANKRUPTCY STATUTES AND GENERAL ORDERS INVOLVED; THE CHARACTER OF BANKRUPTCY FUNDS.

Before stating the grounds relied upon by Petitioner for certiorari, it seems advisable to call attention to the two sections of the Bankruptcy Act, and to the General Order in Bankruptcy, upon which the Court of Appeals predicated its ruling adverse to Petitioner. Section 61 of the Bankruptcy Act, 11 USCA 101, provides:

> "61. Courts of bankruptcy shall designate, by order, banking institutions as depositories for the money of the bankrupt estates, as convenient as may be to the residences of trustees, and shall require bonds to the United States, subject to their approval, to be given by such banking institutions, and may from time to time as occasion may require, by like order increase the number of depositories or the amount of any bond or change such depositories; Provided, That no security in form of a bond or otherwise shall be required in the case of such part of the deposits as are insured under section 264 of Title 12."

Section 47 of the Act*, 11 USCA 75, relating to the duties of Trustees in Bankruptcy, includes the following provisions:

> "Trustees shall * * * (2) Deposit all money received by them in designated depositories. * * *

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* Section 47 of the Bankruptcy Act, being of some length, is set forth in its entirety in the Appendix to this petition.

(4) Disburse money only by check or draft on such depositories."

General Order in Bankruptcy No. 29, promulgated by this Court, is as follows:

"29. No moneys deposited as required by the Act shall be drawn from the depository unless by check or draft, signed by the clerk of the court or by a receiver or trustee, and countersigned by the judge, or by a referee, or by the clerk or his assistant under an order made by the judge, stating the date, the sum, and the account for which it is drawn. An entry of the substance of each check or draft, with the date thereof, the sum drawn for, and the account for which it is drawn, shall be forthwith made in a book kept for that purpose by the receiver or trustee; and all checks and drafts shall be entered in the order of time in which they are drawn, and shall be numbered in the case of each estate. A copy of this general order shall be furnished to the depository, and also the name of any clerk authorized to countersign said checks."

It was solely upon the framework of the two foregoing sections of the Bankruptcy Act, and of General Order No. 29, that the Court of Appeals based its conclusion that an undesignated banking institution's acceptance of a deposit of bankruptcy funds, even in a rural community where there were no designated depositories, would subject the Bank to *absolute liability* for the Trustee's defalcations, though there was no knowledge on the Bank's part that the Trustee was engaged in misappropriating funds. With all deference, we submit that the Court of Appeals read into the Bank-

ruptcy Act something which is not there. The question here is not what may have been the duty of the Trustee in depositing the checks; *the question is what responsibility the Bank incurred when it innocently accepted the deposit.* Sections 61 and 47 of the Act do not say that the acceptance of a deposit of bankruptcy funds by an undesignated bank constitutes an illegal act or breach of trust on its part.

This was aptly pointed out by the Supreme Court of Minnesota in *Rodgers v. Bankers National Bank,* 179 Minn. 197, 229 N.W. 90 (1930), where the Court said, at pages 95-97 of 229 N.W.:

> "* * * The purpose of these sections of the act and the order is to safely keep the money. They are directed to the trustee and to the designated depository. They protect the creditors against weak and insolvent banks. Defendant was not a designated depository. * * * *The provisions of the Bankruptcy Act and the general order mentioned were not meant to regulate the conduct of a bank which is not a designated depository.* They were not intended to change the law applicable generally to a bank receiving fiduciary funds. Nor were they intended to define the liabilities of banks generally having business relations with trustees in bankruptcy. There is no reason or principle permitting us to extend the protective provisions beyond their special purposes. They alone furnish adequate protection to the estate. Nothing else is necessary. We should not, therefore, impose added burdens upon those who are not reasonably within their operation. *There is no reason to construe these efficient protective measures as imposing additional liabilities upon*

> *a bank which has never become a designated depository* and in which the trustee has not opened his checking account, in his name as such trustee.
>
> * * * * * * *
>
> *We are reluctant to read into the Bankruptcy Act or the General Orders an intention, nowhere expressed therein, to change the general rules governing the liabilities of banks in dealing with fiduciaries.* Laws must be construed, if reasonably possible, to facilitate business and promote the general welfare." (Italics ours)

Indeed, in the District Court, Respondent seems to have taken the same view, for in its opinion the District Court quoted the following statement from Respondent's brief:

> "It is not contended by the plaintiff that there is anything in the federal statutes, rules and orders, which, without more, imposes an absolute liability in the premises upon the defendant" (R. 88).

The situation with respect to bankruptcy funds is quite different from that pertaining to a deposit of *public funds,* for there is an express Act of Congress applicable to the latter. Section 96 of the Criminal Code, 18 USCA 182, provides as follows:

> "96. *Banker receiving unauthorized deposit of public money.* Every banker, broker or other person not an authorized depository of public moneys, who shall knowingly receive from any disbursing officer, or collector of internal revenue, or other agent of the United States, any public money on deposit, or by way of loan or accommodation, with or without interest, or otherwise than in payment of

a debt against the United States, or shall use, transfer, convert, appropriate, or apply any portion of the public money for any purpose not prescribed by law; and every president, cashier, teller, director, or other officer of any bank or banking association who shall violate any provision of this section is guilty of embezzlement of the public money so deposited, or applied, and shall be fined not more than the amount embezzled, or imprisoned not more than ten years, or both."

Thus, by Section 96, the mere acceptance of a deposit of public money by a banking institution "not an authorized depository of public moneys" is illegal and constitutes a criminal offense. But there is no such statutory prohibition applicable to bankruptcy funds, as it is settled that they are *private funds,* and not public funds. In *United States ex rel. Willoughby v. Howard,* 302 U.S. 445 (1938), at page 453, this Court said:

> "For federal public funds Congress has provided a depository system by which the moneys, as soon as deposited, are in effect in the Treasury of the United States. * * * Similar provision has been made in many states for the deposit of public funds of the state or municipality. But the funds of bankruptcy estates are private funds. * * * and the provisions in the Bankruptcy Act concerning the appointment of depositories and the deposits to be made by Trustees are of a very different character."

The highest court in West Virginia law has also held that bankruptcy funds are *private* funds: *Townshend v. Ward,* 120 W. Va. 655 (1938).

GROUNDS RELIED ON FOR ALLOWANCE OF WRIT OF CERTIORARI.

At the threshold of this case is the question of whether the fundamental issue involved—the determination of what responsibility the Bank assumed upon acceptance of the deposit of bankruptcy funds—is to be determined under West Virginia or Federal law. The District Court applied the West Virginia law (R. 84, 91). The Court of Appeals said the Federal law controlled (R. 331). From either viewpoint, we respectfully submit that the ruling of the Court of Appeals merits a review on certiorari and falls within the recognized grounds for such review, as outlined in Section 5 of Rule 38 of this Court.

I.

The Court of Appeals here erroneously decided an important question of local law in direct conflict with applicable decisions of the highest West Virginia Court. It erred in not applying the West Virginia law, in accord with principles laid down by this Court in Erie Railroad Company v. Tompkins, 304 U. S. 64 (1938) and kindred cases, including the recent case of Meredith v. City of Winter Haven, 64 S. Ct. 7 (1943).

Respondent's complaint alleged diversity of citizenship as the ground for invoking the jurisdiction of the District Court (R. 2). The mere fact that Petitioner happened to be a National Bank did not, of course, make the West Virginia law inapplicable: *Aetna Casualty and Surety Company v. Catskill National Bank,* 102 F. (2d) 527 (CCA 2, 1939). Although administered by bank-

ruptcy courts under an Act of Congress, the moneys of a bankrupt's estate are *private funds*: *United States ex rel. Willoughby v. Howard,* 302 U.S. 445 (1938). While the Bankruptcy Act provides for designated depositories, in which the Trustees are to make their deposits, there is nothing in the Act, either express or implied, that imposes the harsh penalty of absolute liability on a banking institution, not designated as a depository, which accepts a deposit of such funds in good faith and without knowledge of the Trustee's misappropriations.

The District Court said that the provisions of the Bankruptcy Act were "not designed to define the liabilities of banks generally having relations with trustees in bankruptcy" (R. 88), and held (R. 91, 84) that the case was governed by two decisions of the highest Court of West Virginia: *United States Fidelity & Guaranty Company v. Home Bank,* 77 W. Va. 665 (1916), and *United States Fidelity & Guaranty Company v. Hood,* 122 W. Va. 157 (1940). One of the cases cited by the District Court, *United States Fidelity & Guaranty Company v. Home Bank,* is a leading case on the subject*; in it the Supreme Court of Appeals of West Virginia said, at page 669 of the opinion:

> "To render a bank of deposit liable for the default or misappropriation by a fiduciary of a trust fund deposited it must have actually participated therein, or with knowledge reaped some benefit therefrom, as by itself appropriating the money or

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* The District Court said, in referring to the decision of the West Virginia Court in the *Home Bank* case:

> "This is one of the leading cases in the country upon the subject here involved, and a case which is cited with approval by most text writers." (R. 82).

receiving it in payment of some individual indebtedness of the fiduciary to it, and thereby rendering itself liable as trustee or otherwise. The mere ordinary benefits of the account of the depositor will not be sufficient to so charge it."

The rule thus adopted by the highest court of West Virginia represents the majority view in the United States: *40 Harvard Law Review,* 1077, 1080; *34 Harvard Law Review,* 454, 469; *Rodgers v. Bankers National Bank,* 179 Minn. 197, 229 N. W. 90 (1930). This view is amply supported by decisions of the federal courts:

Empire Trust Company v. Cahan, 274 U. S. 473 (1927);

Atlantic Company v. Barnes, 95 F. (2d) 273 (CCA 5, 1938);

Aetna Casualty and Surety Company v. Catskill National Bank, 102 F. (2d) 527 (CCA 2, 1939);

Maryland Casualty Company v. City National Bank, 29 F. (2d) 662 (CCA 6, 1928), cert. denied, 279 U. S. 847;

Bank of Vass v. Arkenburgh, 55 F. (2d) 130 (CCA 4, 1932), cert. denied, 286 U. S. 561.

The rule of non-liability adopted in the majority of jurisdictions has been carried into the Uniform Fiduciaries Act, which is in effect in a number of states: *40 Harvard Law Review,* 1085-6.

But the Fourth Circuit Court of Appeals declined to follow the two West Virginia cases cited by the District Court. The Court of Appeals said:

"We would be in accord with the conclusions reached by Court below if the only principles here

applicable were those controlling in the case of deposit and withdrawal of funds by an ordinary fiduciary, where nothing in the law forbids the deposit of trust funds in the personal account of the trustee or in the bank in which the deposit is made" (R. 326).

But, as we have pointed out before, where is there anything in the Bankruptcy Act, or elsewhere in the Federal statutes, which forbids the deposit of bankruptcy funds in an undesignated depository, and makes it illegal for such a banking institution to accept the deposit, under penalty of absolute liability for any funds so accepted?

The Court of Appeals concluded that the West Virginia law was not controlling. It said:

> "In determining the liability of a bank for a deposit of bankruptcy funds made in violation of the terms of the Bankruptcy Act, however, we do not understand that we are bound by decisions of the local courts; for the question involved is one of federal rather than local law" (R. 331).

It is respectfully submitted that in this conclusion the Court of Appeals erred, and that it should have been guided by the principles of *Erie Railroad Company v. Tompkins,* 304 U. S. 64 (1938) and kindred decisions of this Court, including the recent case of *Meredith v. City of Winter Haven,* 64 S. Ct. 7, decided November 8, 1943.

When the Court of Appeals said that the deposit here was made "in violation of the terms of the Bankruptcy Act", we submit it made a wholly unwarranted assumption, at least in so far as the legal responsibility

of the Bank was concerned. The Bankruptcy Act does not say, as does Section 96 of the Criminal Code relating to "public funds", that it was illegal or improper for Petitioner to accept the deposit, irrespective of what may have been the duty or proper practice of the Trustee in that respect.

Had the Court of Appeals applied the applicable West Virginia decisions, it must necessarily have reached the same conclusion as the District Court, for there can be no doubt as to the West Virginia law on the subject. Indeed, the West Virginia Court has passed upon a case involving a deposit of bankruptcy funds. In *Townshend v. Ward,* 120 W. Va. 655 (1938), a Trustee in bankruptcy sued the Receiver of a closed state bank in West Virginia to recover bankruptcy funds deposited by the Trustee before the bank failed. The bank had been designated as a depository by the bankruptcy court, subject to the following requirement as to the furnishing of a bond:

> "In the event the amount on deposit * * * exceeds the amount of the bond as above, the bank shall at once increase its bond to cover said excess."

The bank thereupon gave surety bonds totalling $40,000.00; but when it closed, the deposit of bankruptcy funds aggregated approximately $35,000.00 in excess of the bonds. It was claimed by the Trustee that the bankruptcy funds deposited in excess of the bonds should be treated as trust funds, on the theory that they were illegal or improperly accepted by the banking institution —the same theory which Respondent advances in the present case. The Supreme Court of Appeals of West Virginia rejected the Trustee's contention, and said, at page 659 of its opinion:

"It is not contended that the subject of this controversy consisted of deposits of government money, either federal, state, or of a subdivision of the state. The deposits of a trustee in bankruptcy are personal and general deposits. Their classification is not altered, in whole or in part, by the fact that their amount exceeds the penalty of the depository bond. This does not change their nature to that of public funds. See as bearing upon this question *United States ex rel. Willoughby v. Howard,* 302 U. S. 445, 453, 58 S. Ct. 309, 82 L. Ed. 352. * * * Cases which involve the deposit of well recognized public funds, we think, for various reasons, are not in point, an example of which is the holding in *Monongalia County Court v. Bank,* 112 W. Va. 476, 164 S. E. 659.

"The Bankruptcy Act does not require a designated depository for bankruptcy funds to refrain from accepting for deposit bankruptcy funds in an amount which exceeds the penalty of its depository bond."

Neither does the Bankruptcy Act, or any other federal statute, require an undesignated bank to refrain from accepting a deposit of bankruptcy funds, under penalty of being adjudged a trustee *ex maleficio.*

It is true the Circuit Court of Appeals intimated that even if it should apply the West Virginia law, the Bank would still be liable (R. 331); and it referred to two West Virginia cases, *Vance v. Kirk's Adm.,* 29 W. Va. 344 (1887) and *Huffman v. Hayden,* 114 W. Va. 660 (1934). But an examination of the last two cited decisions will disclose that they have absolutely no application to the present case, either on the facts involved,

or the law therein pronounced. The West Virginia decisions which are controlling are *United States Fidelity & Guaranty Company v. Home Bank,* 77 W. Va. 665 (1916), and *Townshend v. Ward,* 120 W. Va. 655 (1938).

It is respectfully submitted that the Court of Appeals erred in not treating the question here involved as a matter of local law, governed by applicable West Virginia decisions; and that upon applying the pertinent decisions of the highest court of West Virginia, the Court of Appeals must have found, as did the District Court, that there was no liability upon the Bank.

II.

The holding of the Court of Appeals is directly contrary to the decision of the Circuit Court of Appeals for the Seventh Circuit in In re Bogena & Williams, 76 F. (2d) 950 (1935); to the decision of the Circuit Court of Appeals for the Sixth Circuit in Irving Trust Company v. United States, 83 F. (2d) 20 (1936); and in principle to the decision of the Circuit Court of Appeals for the Fifth Circuit in Hancock County v. Hancock National Bank, 67 F. (2d) 421 (1933).

In the present case, the Court of Appeals based its decision against Petitioner upon the theory that the deposit of bankruptcy funds in an unauthorized depository automatically gave rise to a "trust *ex maleficio*". The following quotations from the opinion of the Court of Appeals are illustrative:

> "A deposit of bankruptcy funds in an unauthorized depository gives rise to a constructive trust, or a trust ex maleficio" (R. 329).

"The liability of the bank with respect to the deposit is that of a constructive trustee, or trustee ex maleficio for the bankrupt estate" (R. 334).

Precisely the opposite conclusion has been reached in the Seventh and Sixth Circuits in cases dealing with bankruptcy deposits in unauthorized depositories.

In *In re Bogena & Williams,* 76 F. (2d) 950 (1935), a deposit had been made in an undesignated depository by the truste of a bankrupt's estate. The bank having failed, the trustee sought a preferred claim against the funds in the possession of the Receiver of the closed bank, on the theory that the acceptance by the bank of the deposit of bankruptcy funds constituted a "trust *ex maleficio*", precisely the same theory which the Fourth Circuit Court of Appeals applied against Petitioner in the present case. The Court of Appeals for the Seventh Circuit rejected the trustee's arguments, and its opinion in so doing is so pertinent here that we quote at some length from pages 952-3:

> *"We think a trust ex maleficio did not arise by reason of the old bank accepting the deposits when it was not a designated United States depository for bankruptcy funds.* A trustee in bankruptcy is vested by operation of law with the title to all the bankrupt's property, except that which is exempt. 11 USCA Sec. 110; *Mueller v. Nugent,* 184 U. S. 1, 22 S. Ct. 269, 46 L. Ed. 405. Ordinarily, when money is deposited in a designated depository bank by a trustee in bankruptcy, it is deposited as other money is, and becomes the property of the bank, leaving the bank a debtor for the amount. Gardner, Trustee, v. Chicago Title & Trust Company, 261 U. S. 453, 43 S. Ct. 424, 67 L. Ed. 741, 29 A. L. R. 622. In

Hancock County v. Hancock National Bank (C. C. A.) 67 F. (2d) 421, a bank designated as a depository for state funds accepted deposits of county funds without giving sufficient bond, as required by the statute of Georgia. It was there held that the bank acquired title to the funds deposited, and was not a trustee ex maleficio. * * *

* * * * * * *

"Appellee, in support of a contrary doctrine, relies upon In re Potell (D.C.) 53 F. (2d) 877; In re Weiss (D.C.) 2 F. Supp. 767; In re Ocean City Title & Trust Company's Bond (D.C.) 6 F. Supp. 311; Allen v. United States (C.C.A.) 285 F. 678; Board of Commissioners v. Strawn (C.C.A.) 157 F. 49; In re Battani (D.C.) 6 F. Supp. 376; Adams v. Champion (C.C.A.) 70 F. (2d) 956. In the Potell case a trustee had not yet been appointed, and that fact was somewhat stressed in the opinion. The Weiss Case was largely based upon the Potell Case, although the trustee had been appointed and had made the deposit. The court thought that made no difference, saying there might be a distinction for technical reasons, not then important, but there was no difference for present purposes. There was, however, the additional fact that the bank had unequivocally and falsely stated to the trustee at the time the deposit was made that it was a duly designated depository for bankruptcy funds, when in fact it was not. That, indeed, was sufficient to render the distinction for other reasons unimportant. In the Ocean City Case, the court held that a surety on a bond given to secure bankruptcy deposits was entitled to have the bond canceled, where the depository substituted for the depository originally

named in the bond was not an official bankruptcy depository. It was further held that the trustees in bankruptcy, in a summary proceeding, could petition the bankruptcy court to direct the receiver of the substituted depository bank to return the deposits. There was no fraud or misrepresentation on the part of the bank, and the court based its ruling on the Potell and Weiss cases. *The Allen Case had to do with public funds of the United States, and the acts complained of were in direct violation of the Criminal Code, R.S. Sec. 5497, 18 USCA Sec. 182.* The Strawn Case related to acts of a bank which were in direct violation of the Ohio statute preventing a general deposit of public funds. In the Battani Case the court refers to different decisions of the federal courts under various states of fact. It discusses the Hancock, Potell and Weiss Cases, supra, and refers to the Strawn Case, and generally to numerous other cases in which it was held that where deposits were made in violation of a prohibitory law they became funds in trust for the depository. The court then said that the deposits in question became trust funds by operation of law (11 USCA Sec. 75 (a) (3)) in case the depository bond was invalid. That question, however, was not before the court, because it held that the bond was valid and that there was no trust. The case of Adams v. Champion relied upon by appellee was reversed by the Supreme Court in a decision rendered February 4, 1935, 55 S. Ct. 399, 79 L. Ed. ...

"Wherein the cases relied upon by appellee are inconsistent with the rule laid down in the Hancock Case we are not willing to follow them. *We think*

there should be and is a difference, so far as the liability of the bank is concerned, between the cases where the bank by mandate of law is prevented from receiving deposits, and those where a trustee is merely required to make his deposits in a certain bank." (Italics ours).

In *Irving Trust Company v. United States,* 83 F. (2d) 20 (1936), certiorari denied: 298 U.S. 686, a trustee of a bankrupt's estate had deposited funds in a banking institution which was not a designated depository for the particular judicial district in which the estate was being administered. The bank having failed, the trustee sought to recover the bankruptcy funds, on the theory that the acceptance of the deposit under such circumstances created a "trust *ex maleficio*". The Court of Appeals for the Sixth Circuit held* that no such trust was created upon the acceptance of the deposit by an ineligible banking institution, saying at pages 23-4 of the opinion:

> "Finally it is contended that if it be held that the Guardian Company was not an authorized depository for funds of foreign trustees and receivers, and that such trustees and receivers are not entitled to participate in the security given by it, then it should be regarded as a trustee ex maleficio, and for that reason the Irving Company should be adjudged a lien on its assets as against other credi-

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* In the earlier case of *Commercial Savings Bank and Trust Company v. National Surety Company,* 294 Fed. 261 (CCA 6, 1923), the Circuit Court of Appeals for the Sixth Circuit held, in a suit by the surety company against the Bank, that the Bank was not liable for loss of bankruptcy funds deposited by a Trustee in his personal account and later misappropriated.

tors. * * * The basis of the Irving Company's contention is that title to the funds never passed to the Guardian Company. There are cases holding that where a public officer, acting in his official capacity, makes a deposit of a public fund in his custody in a bank without authority so to do, and where the bank has no authority to receive the deposit, the title does not pass and the fund may be recovered if traced. Board of Com'rs v. Strawn, 157 F. 49, 15 L.R.A. (N.S.) 1100 (C.C.A. 6); Empire State Surety Co. v. Carroll County (C.C.A.) 194 F. 593; Allen v. United States (C.C.A.) 285 F. 678; American Surety Co. v. Jackson (C.C.A.) 24 F. (2d) 768, 769. These cases involved funds belonging to a governmental unit deposited in a bank in violation of a prohibitory statute. The theory on which they were decided, it would seem, is that when a bank is prohibited by statute from accepting a deposit, title does not pass as in the case of an ordinary deposit, and although possession passes, the right of possession remains where it was before the deposit was made—with the holder of the title, who may exercise the right when he finds the fund. The same theory has been applied by some of the District Courts to deposits by trustees of funds of bankrupt estates in banks not designated as depositories or in designated depositories which failed to give security. In re Potell, 53 F. (2d) 877 (D.C.E.D.N.Y.); In re Weiss (D.C.) 2 F. Supp. 767; In re Ocean City Title & Trust Company's Bond (D.C.) 6 F. Supp. 311; Hillsdale Grocery Co. v. Union & People's Nat. Bank (D.C.) 6 F. Supp. 773. See, also, in re Battani (D.C.) 6 F. Supp. 376, dicta to the same effect. We think it was erroneously

applied, for *the trustee takes title to the bankrupt's funds* (11 USCA Sec. 110 (a)); Isaacs v. Hobbs Tie & T. Co., 282 U.S. 734, 51 S. Ct. 270, 75 L. Ed. 645), *which are private funds.* Florida Bank & Trust Co. v. Union Indemnity Co., 55 F. (2d) 640, 641, 83 A.L.R. 1102 (C.C.A. 5). And *when the funds are deposited in a bank, the ordinary relation of creditor and debtor arises between the trustee and the Bank.* Gardner v. Chicago Title & Trust Co., 261 U.S. 453, 456, 43 S. Ct. 424, 67 L. Ed. 741, 29 A.L.R. 622. *In such case there is no trust ex maleficio."* (Italics ours)

Both the Seventh and Sixth Circuit Courts of Appeal, in their opinions above quoted, considered, and either rejected or distinguished, the five District Court decisions relating to bankruptcy deposits cited and relied upon (R. 329) by the Fourth Circuit Court of Appeals in the present case. And it is significant that the Court of Appeals for the Fourth Circuit recognizes in its opinion that there is conflict between its decision here and the foregoing decisions in the Seventh and Sixth Circuits (R. 329).

Another Circuit Court of Appeals decision conflicting in principle with the ruling of the Fourth Circuit Court of Appeals is *Hancock County v. Hancock National Bank,* 67 F. (2d) 421 (CCA 5, 1933)*.

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* In an earlier case dealing with a deposit of bankruptcy funds, *Lamb v. Townshend,* 71 F. (2d) 590, 594, (C.C.A. 4, 1934), the Court of Appeals for the Fourth Circuit cited with approval the *Hancock County* case from the Fifth Circuit; but it failed to apply the principles of that decision in the present case.

We respectfully submit that the decision of the Court of Appeals for the Fourth Circuit is in irreconcilable conflict with the decisions from the Seventh and Sixth Circuits above referred to, as to the legal effect of the acceptance of a deposit of bankruptcy funds by a bank not designated as a depository by the bankruptcy court. The question is an important one, and of frequent occurrence; and such conflict should be resolved by an authoritative decision of this Court.

III.

The decision of the Court of Appeals, in treating the deposit of bankruptcy funds made in Petitioner's bank on the same basis as "public funds", is in conflict with the principles of law declared by this Court in the case of United States ex rel. Willoughby v. Howard, 302 U. S. 445 (1938).

The Court of Appeals conceded that bankruptcy funds are private and not public funds, but failed to give effect to this vital distinction. It said:

> "* * * It is true, as argued, that such funds are private and not public funds; but this is a distinction without a difference. The controlling consideration is that, just as in the case of public funds, the law requires deposit in a designated depository, that deposit elsewhere is without legal authority and that a bank receiving the deposit with notice of its trust character must hold it subject to the trust or respond in damages for failure to do so." (R. 329).

Thus, the Court of Appeals, in effect, treated the deposit of bankruptcy funds on precisely the same basis

as if it had been a deposit of Federal "public funds" made in Petitioner's bank in violation of Section 96 of the Criminal Code, hereinbefore referred to. Indeed, the Court of Appeals cited and relied upon "public fund" cases. (R. 328).

In committing what we conceive to be this fundamental error, the Court of Appeals departed from the principles laid down by this Court in *United States ex rel. Willoughby v. Howard,* 302 U.S. 445 (1938). This Court there said, at page 453:

> "The contention that the Bankruptcy Act established a depository system which relieved trustees and receivers wholly of the duty of exercising care as to the condition or stability of a depository rests upon false analogy. For federal public funds Congress has provided a depository system by which the moneys, as soon as deposited, are in effect in the Treasury of the United States. 31 U.S.C.A. Sec. 476-478, 495; 12 U.S.C.A. Sec. 391, 392. Under that system an officer who has duly made the deposits is relieved of all responsibility for the stability of the depository. Similar provision has been made in many States for the deposit of public funds of the state or municipality. *But the funds of bankruptcy estates are private funds,* see Texas & P. R. Co. v. Pottorff, 291 U.S. 245, 257, note 11, 78 L. Ed. 777, 784, 54 S. Ct. 416, and *the provisions in the Bankruptcy Act concerning the appointment of depositories and the deposits to be made by trustees are of a very different character.*" (Italics ours)

The West Virginia Court is in accord that bankruptcy funds deposited in a banking institution must be

treated solely as *private* funds: *Townshend v. Ward,* 120 W. Va. 655 (1938). And in *In re Bogena & Williams,* and *Irving Trust Company v. United States,* cited *supra,* both the Seventh and Sixth Circuit Courts of Appeals pointed out that a deposit of bankruptcy funds does not fall within the same category as a deposit of "public funds" in an unauthorized depository in violation of Section 96 of the Criminal Code.

IV.

The question involved is of national significance and importance beyond the present case. The harsh rule adopted by the Court of Appeals removes bankruptcy funds from the field of normal banking transactions. The question should be settled by an authoritative decision of this Court.

The question presented here is an important one, and of rather frequent occurrence. It arises wherever a trustee in bankruptcy makes a deposit in a banking institution not designated as a depository by the bankruptcy court. In rural communities such designated depositories are not always available. There was no such depository at all in Doddridge County, West Virginia, where Petitioner's bank is located. The Trustee here made the deposit in his local bank, where he kept his personal account. The rule of absolute liability applied by the Court of Appeals to Petitioner, in the admitted absence of any knowledge on Petitioner's part that the Trustee was misappropriating bankruptcy funds, seems unduly harsh. It is applied in the absence of any federal statute making it illegal for an undesignated bank to accept such a deposit. The Court of Appeals has not cited, in support of its harsh rule, any case involving

bankruptcy deposits, aside from some District Court decisions which, as we have seen, have been criticized or repudiated by both the Seventh and Sixth Circuit Courts of Appeals.

In treating a deposit of bankruptcy funds on a different basis from a deposit of other "private funds", the Fourth Circuit Court of Appeals not only stands alone among Federal appellate courts, but it also removes bankruptcy funds from the field of ordinary banking transactions. Contrast this with what was said by the New York court in *Maryland Casualty Company v. Central Trust Company,* 39 N.Y. Sup. (2d) 293, 265 App. Div. 416 (1943), at pages 296 and 298:

> "* * * respondents further contend that in view of the fact that these were the deposit of bankruptcy estate funds, pursuant to a court order, the opening of such account created more than the ordinary debtor and creditor relationship in that the deposited funds were impressed with the trust of a quasi public nature for the benefit of a group of creditors and under the protection of acts of Congress and rules of the United States Supreme Court.
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> The question involved on this review is whether deposits made of bankrupt estate funds are to be considered, or not to be considered, as ordinary banking transactions.
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> * * * * * * *
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> * * * when the Government of the United States devised a method of handling bankrupt estates for the purpose of liquidating businesses which were in financial distress, then there was no particular reason to regard the handling of such estates as other than commercial transactions governed by the

laws and rules applicable to the ordinary banking transactions. The conclusion is therefore reached that in actions brought on behalf of the depositor, or by one who stands in the shoes of the depositor, although the deposit is of bankruptcy funds, it is a suit subject to the defenses which may be pleaded in the ordinary depositor—bank suits * * *".

We think it can be said here, as was said by Mr. Justice Holmes in *Empire Trust Company v. Cahan,* 274 U.S. 473, 478 (1927):

> "The court below applied too strict a rule to an ordinary business transaction."

The rule here adopted by the Court of Appeals is particularly harsh because Respondent is not merely attempting to impress a trust upon funds in the hands of Petitioner, such as would be the case if the claim were asserted against the Receiver of a closed bank. Here, the funds are gone and the attempt is to thrust personal liability upon the Bank.

As was aptly pointed out by the Supreme Court of Minnesota in *Rodgers v. Bankers National Bank,* 179 Minn. 197, 229 N.W. 90 (1930), at page 95 of 229 N.W., where a trustee in bankruptcy sought recovery against a bank upon similar facts:

> "This is not a case to impress a trust on funds in possession of the bank. The funds are gone. This action seeks to impose a personal liability upon the bank because of an alleged violation of its duty."

Rodgers v. Bankers National Bank, supra, contains an able and exhaustive discussion of the very same question involved in the present case. The Minnesota court

reached a conclusion directly contrary to that of the Circuit Court of Appeals for the Fourth Circuit, and absolved the defendant bank of liability for the bankruptcy funds deposited with it.

For the foregoing reasons, it is respectfully submitted that the writ of certiorari herein prayed for to the judgment of the Circuit Court of Appeals for the Fourth Circuit should be granted.

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